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No. 94-1239

IN THE SUPREME COURT OF THE UNITED STATES

October Term 1994

FULTON CORPORATION,

Petitioner,

v.

JANICE H. FAULKNER, SECRETARY OF REVENUE,

Respondent.

On Writ of Certiorari to the
Supreme Court of North Carolina

REPLY BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Whether the North Carolina intangible personal property tax on the value of corporate stock owned by shareholders discriminates against interstate commerce in violation of the United States Constitution by taxing one hundred percent of the value of stock of corporations that do no business in North Carolina, but exempting from taxation the stock of corporations that do business only in North Carolina, and reducing the taxable value of the stock of other corporations proportionately as the amount of business done by the corporation in North Carolina increases.

RULE 29.1 STATEMENT

Pursuant to Rule 29.1 of the Rules of this Court, petitioner Fulton Corporation states that it has neither a corporate parent nor a corporate subsidiary.

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INTRODUCTION

The Secretary admits, as she must, that the intangibles tax discriminates against interstate commerce, both facially and in operation. Resp. Br. 9, 10, 44. Her

new theory of why it is a constitutionally permissible compensating tax is preposterous.

There is no evidence, admissible or otherwise, that the intangibles tax on stock was designed or intended to make multistate corporations pay "for the privilege of participating in North Carolina's capital markets." Resp. Br. 29. The Secretary never mentioned this new theory in this case prior to filing the Brief of Respondent, and the North Carolina Supreme Court did not utilize it in this case. The entire history and structure of the corporate income and intangibles taxes show that one taxes corporate income earned from business activity in the state and the other taxes intangible property having a business situs, or owned by residents, in the state. Neither is a tax *upon* access to capital markets.

The two taxes by definition are not equivalent. The income tax varies *only* and directly with income earned from business activity in the state. The aggregate intangibles tax paid by all of a corporation's North Carolina shareholders varies directly with the proportion of corporate income earned out of state, directly with the number of shares held by residents of the state, and directly with the value of the shares.

Unlike any other compensating tax scheme that this Court has upheld, this scheme *causes* discrimination against interstate commerce by operating to exert an inexorable hydraulic pressure on interstate commerce to ply their trade within North Carolina. As illustrated below, the stock tax increases as the proportion of corporate

income earned out of state increases, with no necessary offsetting decrease in corporate income tax paid to the state.[1] This discrimination does not depend on the internal consistency test for its proof.

Illustration:

YEAR 1

All shareholders reside in NC

CORPORATION X

Earns $100 income
100% in NC

Shareholders' Aggregate NC Intangibles Tax = zero

X's NC Corporate Income Tax = $10 at 10% rate

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[1]Resondent's Brief at 34 incorrectly implies that the income tax decreases as the aggregate stock tax increases.

<u>YEAR 2</u>

All shareholders reside in NC

CORPORATION X
Earns $100 income in NC and $100 income in VA

Shareholders' Aggregate NC Intangibles Tax = tax on 50% of stock value	X's NC Corporate Income Tax = $10 at 10% rate

The Secretary thus asks this Court to do what it has never before done -- create a major new exception to the prohibition against taxes that operate to discourage interstate commerce and that thereby erect preferential trade zones in violation of the Commerce Clause.

ARGUMENT

A. The North Carolina Corporate Income Tax is Not a Levy on Intrastate Commerce for Which the State Needs to Compensate.

The Secretary's Brief understandably spends far more space discussing constitutional principles than analyzing the practical applications of her new theory. The major premises of the Secretary's new theory, summarized in the most favorable light, are: (1) one of the "state's

services" for which the corporate income tax is levied is the maintenance of the state's "capital market" (Resp. Br. 20); (2) the income tax is an intrastate tax burden on corporate income earned in the state, which is charged in part for this service; (3) the state can compensate therefor by indirectly taxing (through a tax on their stocks)[2] corporations that purportedly enjoy the purported "state service" because they have shareholders in the state, but do not pay for the service (or fully pay for it) because they do not pay to the state tax on 100% of their income; consequently, (4) the aggregate[3] intangibles tax on stock of a corporation held by North Carolina residents compensates for the state's inability to tax the corporation's income earned out of state, and the income and aggregate intangibles taxes are proxies for each other. Resp. Br. 14.

1. The Secretary's new theory is illogical on its own terms.

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[2]The Secretary's Brief goes to great lengths to argue that the stock tax is not *on* the shareholder but is *on* the corporate income or property. See Resp. Br. 13-14, rejecting Fulton's characterization of the stock tax in *Darnell* as a tax on stock, prepaid by the corporation, and insisting that the stock tax is an indirect tax on the corporation's income.

[3]See Resp. Br. 7 (referring to the aggregate "tax liability of its shareholders"); 28 (quoting the opinion of the Supreme Court of North Carolina referring to the aggregate of "intangibles tax against shares").

The Secretary's Brief created out of whole cloth the novel theory that North Carolina enacted the discriminatory deduction in its intangibles tax on stock in order to make multistate corporations indirectly pay for "their fair share of the cost of maintaining North Carolina's capital market." Resp. Br. 20. The theory is illogical because it has no consistent explanation of how that fair share is measured. *See Oregon Waste Systems, Inc. v. Dept. of Env. Quality*, 114 S. Ct. 1345, 1352-1353 (1994) ("Respondent's failure to identify a specific charge on intrastate commerce equal to or exceeding the surcharge is fatal to their claims.")

The only remotely logical ways the "fair share" argument could work would be that either (1) the "fair share" is direct or indirect (through the intangibles tax) tax on 100% of a corporation's income, or (2) the "fair share" is direct or indirect (through the income tax) tax on so much of a corporation's stock value as is held by residents of the state. The Secretary's argument focuses almost entirely on showing the stock tax to be an indirect tax on income, or the income tax to be an indirect tax on stock, without addressing the facts that the income tax *does not vary with stock ownership* in the state and that the aggregate stock tax is not a proxy for tax on all of the income earned out of state because it *applies only to the extent* of shares held in the state.

Illustration:

99 shares owned by VA residents

1 share owned by NC residents

Corporation X	
Earns income in VA of $100	Earns income in NC of $100
Aggregate NC Intangibles Tax = indirect tax on $1 (1%) of VA income of $100[4]	X's NC Income Tax = tax on $100, which is 100% of NC income

This *Illustration* shows that neither is the North Carolina corporate income tax a proxy for the aggregate stock tax, nor is the aggregate stock tax a proxy for the North Carolina income tax.

Furthermore, the residence of shareholders has no necessary relation to the corporation's intentionally accessing the state's capital market by selling stock to

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[4]The value of 1 share minus 50% of the value of one share times the intangibles tax rate is the intangibles tax, which is a proxy for an indirect tax on 1% of X's VA income, under the Secretary's new theory.

North Carolina residents through channels of commerce in the state.[5]

Thus, the new theory is illogical and arbitrary on its own terms. This illogic shows that intentional adoption of the taxing scheme at issue for the asserted purpose cannot be inferred, particularly in the absence of any extrinsic evidence of such purpose, as discussed below in section 2.

The theory's illogic is rooted in its confusion of the existence of the myriad of benefits of living in an organized society (of which the presence of a capital market may be one) with the levying of a tax *upon* a particular event or subject. The corporate income tax is not levied *upon* any event that can be related to access to capital market, and therefore it bears no logical relation to the intangibles tax on stock, even if that tax could be viewed as somehow related to access to the capital market. Consequently, the two taxes cannot be linked into a logical regime for purportedly taxing access to capital markets.

The Secretary cannot distinguish *Oregon Waste,* 114 S. Ct. 1345. Oregon also tried to portray "general taxation" as the intrastate tax to be compensated for by a per unit tax on out-of-state waste disposal. The Court stated that earning income (for purposes of general income taxation) was not equivalent to waste disposal. The

[5] *Cf.* Resp. Br. 17, 20, which incorrectly characterizes the intangibles tax as one imposed on *selling* stock in North Carolina.

Secretary argues that corporate income and stock values are somewhat more interrelated (Resp. Br. 33) (although it also could be said that the more waste one disposes of, the more income one probably would have). Even if that were so, the corporate income tax is not levied upon an *event* and a tax base similar to that on which the intangibles tax is levied - aggregate of stock owned by residents - and *vice versa.*

As a further analogy to *Oregon Waste,* the aggregate stock tax here can go up when the income tax paid to North Carolina remains constant, this occurring on account of the corporation earning additional income out of state as illustrated in the Introduction, above. Therefore, contrary to the Secretary's assertion, her new theory *does* make the fallacious argument that "the state income tax may serve as an all-purpose compensatory justification for discriminatory taxes imposed on interstate commerce." Resp. Br. 35.

Finally, the tax in *Darnell v. Indiana,* 226 U.S. 390 (1912), which the Secretary contends is "in all essential aspects identical," was not justified as a tax on the corporation's access to the capital markets, but as a tax for the resident *shareholder's* benefits from the state. Resp. Br. 11-13 (quoting the Indiana Supreme Court).

2. The Secretary has offered no proof for her new theory of the compensatory function of the stock tax.

The opinion below of the North Carolina Supreme Court did not mention the Secretary's new theory and neither has the Secretary in over four years of litigation in this case in the trial court, the North Carolina Court of Appeals, the Supreme Court of North Carolina, or in her two prior submissions to this Court in this case.

The "purpose" of the corporate income tax is the imposition of "a tax for the use of the State government upon the net income of every domestic corporation and of every foreign corporation doing business in the State." N.C. Gen. Stat. §105-130.1. "Doing business" is "the operation of any business enterprise or activity in North Carolina for economic gain, including, but not limited to, the following: [none of which has anything to do with selling stock] . . . ." N.C. Admin. Rule 17:5C.0102. The intangibles tax on stock is a *property* tax levied under Article V, §2(2) of the North Carolina Constitution, which authorizes *property* taxes. N.C. Gen. Stat. §105-198.

The extra-record submission lodged by the Secretary with the Court contains no hint of the new theory. Her Brief points only to a single sentence in a 1928 Report to the Governor justifying the then current system of *not* taxing domestic corporate stock, by a reference to the imposition of both the domestic property tax and excess profits tax. Resp. Br. 21-23. The Secretary has established no causal or factual linkage between the 1928 Report and the 1939 enactment of the taxing regime at issue. Contrary to the assertion in the Secretary's Brief, that Report *did not* recommend exempting shares to the extent the issuing corporation paid income tax to the state.

Resp. Br. 4, 22-23. The Secretary offered no evidence that even the 1937 version of the intangibles tax constituted an intentional adoption of part of the Report's recommendations.

Fulton's evidence in the record before this Court includes the deposition of the knowledgeable state employee, Frank Goodrum, Jr., who became an intangibles tax auditor in 1958, assistant director of the Intangibles Tax Division in 1967 and Director in 1977, continuing to the time of the deposition in 1991. Goodrum Depo. 4-5. He was asked about the purpose of the intangibles tax and the deduction and he supplied under subpoena two explanations prepared in his Department of the tax. His explanations clearly identify the purpose of the deduction as avoidance of double intrastate taxation *of property*, and made no reference to the novel theory now espoused by the Secretary.[6] Goodrum Depo. 25-34.

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[6]He stated his understanding to be that the multistate corporation that paid tax on 30% of its income to North Carolina was *presumed to have 30% of its property in North Carolina*, where it paid tax on that property. Goodrum Depo.28. He stated that there was no factual account of that theory. Goodrum Depo.29. Attached to his deposition as Exhibits 4 and 5 are histories of the intangibles tax on stock written by the Department of Revenue that give no explanation of the stock tax deduction. These two exhibits were the fruits of a search within the Department for any explanation of the operation of the tax. Goodrum Depo. 63-64.

Finally, the theory that the intangibles tax is a tax on corporate access to capital markets is refuted by the fact that North Carolina has chosen to "charge" for all the privileges available to a business entity in the state through the franchise tax, which is distinct from the corporate income tax. N.C. Gen. Stat. §105-114 (imposing the franchise tax "for the benefit and protection which such corporations receive from the government and the laws of this state in doing business in this state . . . " and defining doing business as "Each and every act, power, or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State"). In addition, North Carolina specifically regulates the privilege of access to its capital markets by the Blue Sky Law, N.C. Gen. Stat. §78A-24 et seq. In connection therewith the state charges securities registration and filing fees. N.C. Admin. Rule 18:6.1304. Aside from the securities registration, a foreign corporation selling its shares to residents of the state through national markets would not even have to register to do business in North Carolina for the "privilege" of access to capital markets. N.C. Gen. Stat. §55-15-01(b).

3. There is no intrastate tax on a substantially equivalent event for which North Carolina needs to compensate.

Fulton does not deny North Carolina's power to tax the stock at 100% of value, and possibly even the power to tax it for this "state service" if the state so desires. Fulton disputes the discriminatory deduction allowed in computing the tax on stock, which has the effect of

converting the aggregate stock tax into a tax on corporate income earned out of state. See Pet. Br. 22-23.

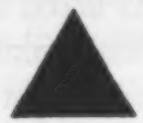
Undoubtedly the Secretary belatedly developed the "capital market" theory in her effort to fulfill the compensating tax defense requirement of a common underlying subject that is taxed upon nominally different but substantially equivalent events, so that one tax can be called a proxy for the other. That is, the compensated and compensating taxes must be bound together as in a triangle, with both being linked to a common subject of taxation: the intrastate part of that common subject is taxed by the compensated tax and the interstate part is taxed by the compensating tax. There is no such linkage here.

In the paradigm compensating tax example of the sales and use taxes, the common taxing subject is the consumption in the state of the goods bought. *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. 1331, 1345 (1995), which recognizes that the taxable events of the sales and use taxes are different - the sales tax falls on the "freedom of purchase," while the use tax falls on the use. The opinion goes on to state, however, that the sales tax is imposed only when the sale is "for consumption." 115 S. Ct. at 1339 and 1341. *See also Associated Indus. of Mo. v. Lohman*, 114 S. Ct. 1815, 1821 (1994) (identifying the purpose of the sales-use tax scheme as making all property "used or consumed in the state subject to a uniform tax burden.") Consequently, the use tax is a proxy for the sales tax as a tax on consumption in

the state and for that reason the sales and use taxes fall on substantially equivalent events and bases.[7]

Illustration:

Consumption in State



Sales Tax Use Tax

Substantially equivalent amounts are collected by the sales and use taxes. However, proving (as the Secretary attempts to do) that the value of stock and corporate income might have some interrelationship as to amount does not prove that the corporate income tax and the intangibles tax are imposed on substantially equivalent events. The intangibles tax is not necessarily paid on all of the stock of even the wholly foreign corporation (it is paid only on the aggregate value of stock of resident shareholders), and the income tax *does not vary* with the presence of shareholders in the state. Therefore, the two tax bases cannot be equivalent. Due to the total lack of connection of the two tax bases, it is impossible for the resulting taxes to have even the "rough approximation" for which the Secretary argues. Resp. Br. 25. *Cf. Alaska v.*

[7]Not to the contrary is a statement in *Maryland v. Louisiana*, 451 U.S. 725, 754 (1981) that equivalent values indicate complementarily. Resp. Br. 32. The values are equivalent because the items consumed activities are equivalent.

Arctic Maid, 366 U.S. 199 (1961) (upholding a 4% and 6% tax regime, where *both* taxes were imposed on the value of fish).[8]

It is true that the use tax is imposed on the purchase price of goods bought outside the state in part because the sale cannot be constitutionally taxed by the state of use, just as the corporate income earned outside the state cannot be taxed. There is, however, a taxable event - the use of the goods - that occurs in the state; moreover, this use is substantially equivalent to the commencement of use upon a taxable sale in state. In contrast, there is no taxable event in the state by virtue of shareholders residing there that is equivalent to 100% of the corporate income earned in the state.

Analogously, in *Armco, Inc. v. Hardesty*, 467 U.S. 638, 643 (1984), Washington's manufacturing tax was not complementary to its wholesaling tax on imported goods because the manufacturing tax did not fall *only* on goods sold in the state as did the wholesaling tax; thus, the two taxes were not proxies for each other and did not fall on common taxing subject, substantially equivalent events, i.e., sales of goods.

[8]*Arctic Maid* was not a true compensatory tax case because the tax at issue was arguably imposed on a nondiscriminatory class of activities. See Hellerstein, *Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*, 39 Tax Law. 405, 414, n. 63 (1986).

4. **The Secretary asks the Court to uphold a compensatory tax that causes discrimination against interstate commerce.**

The Secretary asks this Court to do something it has never done: to approve as a compensatory tax a tax that is part of a scheme that discriminates: ". . . which means that the taxable percentage deduction furthers a legitimate local purpose . . . that cannot be achieved by nondiscriminatory means." Resp. Br. 9.

A compensatory tax cannot be discriminatory in effect against interstate commerce, as illustrated by the Court's discussion of the need for compensatory taxes to satisfy "well understood constitutional strictures" requiring "[E]qual treatment for in-state and out-of-state taxpayers similarly situated"). *Jefferson Lines*, 115 S.Ct. at 1342, n.6. That equal treatment in the sales/use tax case is insured by a credit against the use tax of sales tax paid to another state. Application of a similar mechanism to the North Carolina scheme would require that the intangibles tax deduction include the percentage of corporate income taxed everywhere, which generally would be 100%, thus negating the intangibles tax.

B. **Avoiding Double Intrastate Taxation Is No Justification For Higher Taxation of Interstate Commerce.**

1. **There would be no privileged position for interstate commerce, absent the disputed deduction.**

Perhaps recognizing the fallacy of her arguments, the Secretary finally argues that the admittedly discriminatory scheme to avoid double intrastate taxation is necessary to avoid giving a privileged position to interstate commerce. Resp. Br. 9, 44. But there would be no privileged position for interstate commerce if the discriminatory deduction did not exist. The internal consistency analysis shows that if all states adopted a residence based stock tax on 100% of value, and imposed the corporate income tax as commonly exists, then about 100% of corporate income will be taxed in the aggregate and 100% of stock value will be taxed, regardless of the presence or absence of interstate commerce. See Pet. Br. 30-32.

This Court has ruled that a state cannot pursue the goal of eliminating double taxation for intrastate commerce at the expense of causing potentially multiple interstate taxation. *Tyler Pipe Indus. v. Wash. State Dept. of Rev.*, 483 U.S. 232 (1987) involved a state that did not want to double tax manufacturers that sold in the state, so it exempted from the manufacturing tax the goods sold in the state by local manufacturers who were subject to the wholesale tax. The Court struck down that exemption because it created potentially multiple interstate taxation under the internal consistency analysis.

This Court need not decide here whether two states can tax the full value of intangible property in order to rule for Fulton. See Pet. 12. The issue here is not whether North Carolina can tax 100% of the value of stock under the Commerce Clause, possibly resulting in duplicative taxation of stock (a Commerce Clause issue not decided by earlier decisions). The issue, according to the Secretary's own theory which posits the aggregate stock tax as a proxy for a tax on corporate income, is whether corporate income can be indirectly taxed through the stock tax, resulting in multiple interstate taxation of corporate income. Unquestionably, the Commerce Clause forbids such multiple taxation of corporate income. *See Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

2. The State would not be "placed in an insurmountable bind."

The Secretary's Brief states that the alternatives to the North Carolina taxing scheme at issue here would "place the State in an insurmountable bind." Resp. Br. 8. The alternative that the stock tax be eliminated seems to suit at least 38 other states. Br. in Opp. to Pet. 13.

Neither does the alternative of taxing stock at full value create any serious problem. North Carolina already engages in "double intrastate taxation" of corporate income, without being in a bind. North Carolina taxes the incomes of corporations and the dividends received by North Carolina taxpayers from those corporations, thus producing double taxation of the same income. This is

ameliorated only imperfectly and partially by a vestige of a former larger offset, now providing a credit of 6% of dividends to a maximum aggregate $300 per year per shareholder (sheltering a maximum of $4,000 of dividends), allowed only to shareholders of corporations that pay North Carolina corporate income tax on 50% or more of their incomes. N.C. Gen. Stat. §105-151.19.

C. *Darnell* And Related Fourteenth Amendment Cases Are Not Controlling

The Secretary principally relies on *Darnell v. Indiana*, 226 U.S. 390 (1912) and the amicus emphasizes *Darnell* and related cases as they dealt with the issue of "double taxation" within one state. In brief, all of these decisions, with the sole exception of *Darnell's* passing reference to the Commerce Clause, involved the rational relationship test of the Due Process clause. The Court early acknowledged, however, that the failure of a state to take account of taxation by another state was unjust:

> But from the point of view of the taxpayer, it does not matter whether all of his double taxation is done in one state or half in one and half in another. He suffers the same injustice. And, as manifestly the clearest right to tax belongs to the state where the railroad has its tracks, every principle of justice and patriotism would require the same abstinence from taxing stocks of the railroads of neighboring state that is practiced with regard to those of the taxing state - in this case Georgia - itself.

Wright v. Louisville & Nashville Railroad Company, 195 U.S. 219 (1904).

As discussed in Petitioner's Brief, subsequent Commerce Clause rulings of this Court have overtaken any incomplete suggestion in *Darnell* that a state can attempt to avoid alleged multiple intrastate taxation by creating multiple interstate taxation. Pet. Br. 33-34. Indeed, as this Court has recently recognized in *Jefferson Lines*, 115 S. Ct. at 1338, "whenever one State's act of overreaching combines with the possibility that another State will claim its fair share of the value taxed," that State's tax will violate the "prohibition of multiple taxation."

CONCLUSION

The judgment of the North Carolina Supreme Court should be reversed.

Respectfully submitted, this the 28 day of August, 1995.

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